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SUBJECT: ICELAND: IT WON'T BE THE BEST PLACE TO LIVE ANYMORE

¶1. (SBU) Summary: Last year Iceland was rated by the UNDP as the best place to live in the world, but the October collapse of the Icelandic banking system has triggered a full scale financial and currency crisis and delivered a knockout punch for Iceland. Now experts are just beginning to piece together what will happen in the economy here and how living standards will be affected. Already we have seen an immediate, rapid rise in unemployment and inflation. There is significant trouble with the Icelandic krona and currency exchange limits have limited foreign trade on this import-dependent island. As a result, business reps predict 70 percent of Icelandic businesses will go bankrupt in the near future. The best hope for the short term is an IMF economic stabilization program awaiting IMF Executive Board approval. However, before the Board can consider the package, Iceland must secure $4 billion in other bilateral loans, and they are only a quarter of the way there. The IMF money will continue the flow of essential goods to Iceland, but real economic recovery will take longer. Iceland must address the creditors of the failed banks to preserve future private sector financing again and the only long-term solution we've heard for the currency crisis is joining the EU and adopting the Euro. End Summary.

¶2. (SBU) The collapse of the Icelandic financial sector in October has triggered an economic crisis, the depths of which are only now becoming clear. Many Icelanders lost all their investments because they owned stock in the three banks that collapsed or other companies that faltered as a result of the banks. Those who had cash savings in some accounts are unsure if their money is still there as many accounts remain frozen. There has been a rapid rise in unemployment in a country that has generally faced labor shortages. The Directorate of Labor reported in September the total number of unemployed was about 1.3 percent unemployment, the number jumped to 3 percent in six weeks and is anticipated to be 7 percent by January. The Central Bank predicts that at the end of 2009, unemployment rates will have reached 10 percent.

¶3. (SBU) As economic conditions worsen, academics and industry experts alike tell Post they expect a brain drain. Iceland's semi-skilled foreign work force is expected to be the first to move away and we have seen anecdotal evidence of that departure already; the Polish Consulate here estimates that half of the roughly 14,000 Poles who moved here to work in the construction and services industries have left Iceland in the last three months. As the condition of the Icelandic labor market deteriorates Icelanders themselves might start thinking about moving abroad. The Chairman the Union of Icelandic Electrical workers stated earlier in the week that hundreds of tradesmen (carpenters, electrical workers, plumbers, masons) are already preparing to move abroad. The Norden Association, an organization that promotes Nordic co-operation, reports a large surge of Icelandic interest in their course that teaches how to establish oneself when moving to a Nordic country.

¶4. (SBU) Inflation, always a problem here, is also expected to spike in the short term despite an overall economic contraction. Currently, twelve month average inflation is being measured at 15.9 percent, and because Iceland is extremely import dependent,

inflation is directly influenced by the (falling) value of the Icelandic krona. According to the Central Bank's baseline forecast inflation will peak at 23 percent in the first quarter of 2009 but will have fallen to 5 percent by the end of the year. This sharp decline in inflation is based on the assumption of moderate wage growth, falling demand for consumer goods, and a stable exchange rate. If these assumptions do not hold, then inflation might reach a higher level and remain high for a longer time, something Iceland hasn't seen since the 1980's.

¶5. (SBU) Businesses report significant difficulties regarding trade and the currency. When the U.K. authorities invoked anti-terrorism and economic crimes legislation against Icelandic banks and froze Icelandic assets on October 8th, virtually all international payments to Iceland stopped. Two days later the Icelandic Central Bank established rations of foreign currencies at a fixed price and gave priority to importers of food, fuel and pharmaceuticals. Importers of clothes, electronics and every other good had to get in line for currency. Post learned of one stationary supply store which waited for three weeks to get foreign currency to import office paper. The Confederation of Icelandic Employers told post that Icelandic businesses are facing serious difficulties that only seem to worsen with each day; on top of the cross-border payment problems and restricted access to foreign currencies, Icelandic companies' standing with their suppliers abroad has suffered greatly. Virtually all transactions have to be pre-paid. Adding to the pain, many businesses took out loans in Japanese yen, which has appreciated 136 percent against the krona and resulted in increases in payments. The Federation of Trade and Services predicts 70 percent of businesses are expected to declare bankruptcy in the near future if the currency crisis is not solved.

¶6. (SBU) For the short term, the IMF assistance is supposed to



provide foreign currency to support re-floating the krona and stabilize foreign trade, however the IMF deal is not assured. The IMF announced on Oct. 24 a $2.1 billion loan provided that Icelanders raise nearly $4 billion more; thus far they have secured loans of just over $1 billion from Norway, Poland and the Faroe Islands. Every day the press speculates who is to blame for no IMF deal, with the clear favorite the U.K. (reportedly blocking the deal until a resolution is created for the failed Icelandic banks in the U.K.) As we understand it, the IMF deal is essential to solving the immediate currency crisis. The Head of the Research Department at Kaupthing Bank reiterated to Emboffs that it is of vital importance to establish a sound currency market in Iceland. He said that once the krona is floated again, it will devaluate further, but no one knows by how much; the main fear with lifting restrictions in the currency market is that of a domestic run, with Icelanders selling krona to get foreign currencies. This seems to indicate that currency restrictions will remain in place in some form even if the IMF loans are approved.

¶7. (SBU) Addressing longer term conditions will require resolving the issues with creditors and depositors and the long term strength of the currency. The British IceSave account holders are still grabbing the headlines, but behind the scenes there are many creditors lining up. Post met with a lawyer representing American bond holders with $3.5 billion invested who plainly stated that if Iceland does not take a transparent and fair path with creditors, investors will never come back. This concept is beginning to be discussed in the media; the most prominent proponent is the head of the Confederation of Employers, who advocates giving the creditors ownership of the banks as a way of preserving Iceland's future access to credit. Most business representatives and economists we talk to do not see a medium or long term solution with the Icelandic krona. Everyone seems to feel the joining of the EU and the adopting of the Euro is not only inevitable, but necessary for long term economic survival.

¶8. (SBU) Comment: The situation here is still fluid, but as the consequences of this crisis continue to play out, we could start to see the development of a permanently unemployed class, which is historically unknown here. Iceland has always had reverse brain drain, where young people are educated abroad, but return to raise

their families. This will likely no longer be the case and young Icelanders abroad will stay there and those who can move away from Iceland will. Foreign travel, very common in recent memory, will be restricted by financial constraints. Once the current stocks of consumer and luxury goods are depleted, there will not be a replenishment to the same level as before. In short, Iceland faces the very real prospect of the rapid undoing of two decades of robust prosperity and a whiplash-inducing return to scrimping and saving unknown since the 1980s. This already bitter pill will take on a new edge if the public holds to its current view that this disaster is the fault of vindictive foreign parties (e.g, the British).

van Voorst